# THE VERTICAL DIVISION OF REVENUE IN SOUTH AFRICA

This fact sheet is based on a research study on the impact of the Covid-19 pandemic on municipal fiscal sustainability in the Western Cape (WC). The study was commissioned by the WC Department of Local Government, and was conducted by the School for Public Leadership at the Stellenbosch University, with the support of the Hanns Seidel Foundation.

## What is the annual vertical division of revenue?

- The South African Constitution assigns most of the buoyant revenue sources (Personal Income Tax, Corporate Income Tax and Value Added Tax) to national government.
- Section 227 of the Constitution, however, entitles local government as a sphere to "an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it".

*The **vertical division of revenue** is the process of splitting the available revenue pool among national, provincial and local governments.*

## Who decides what the annual vertical division of revenue will be?

The vertical division of revenue is largely a political decision recommended by the Budget Council and the Local Government Budget Forum and approved by Cabinet.

**The Budget Council**, formalised by the Intergovernmental Fiscal Relations Act of 1997, is chaired by the Minister of Finance and the Members of the Executive Council of Finance of each province (MECs for Finance). The Financial and Fiscal Commission may also attend the Budget Council as observers.

**The Budget Forum** is a platform for the national government to consult the nine provincial governments and organised local government (SALGA) on any fiscal, budgetary or financial matter affecting the local sphere of government. It consists of the Minister of Finance as the chairperson, the MEC for Finance of each of the nine provinces, five representatives of SALGA at national level, and a SALGA representative from each province.

## What is the horizontal division of revenue?

Once the revenue allocation to local government as a sphere is determined through the vertical division of revenue, this amount is further split up among individual municipalities by means of a transparent formula, based on a number of variables such as the number of households in a municipality and proxies for the cost of basic service delivery.

*This process is called the **horizontal division of revenue.***

## How much does the revenue sharing process allocate to national, provincial & local spheres of government?

The tax revenues collected by SARS and the amount borrowed by National Government sets the spending limit for the main budget, represented by the line "main budget expenditure" in the table below.

*Table 1: The planned and actual vertical division of revenue in South Africa, 2021*

| R billion | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 | Average annual MTEF |
|---|---|---|---|---|---|---|---|---|
| | Outcome | | | Revised estimate | Medium-term estimates | | | |
| **Main budget expenditure** | **1 404.9** | **1 506.6** | **1 690.9** | **1 804.2** | **1 834.3** | **1 870.8** | **1 911.0** | **1.9%** |
| *Percentage increase* | *7.6%* | *7.2%* | *12.2%* | *6.7%* | *1.7%* | *2.0%* | *2.1%* | |
| *Less:* | | | | | | | | |
| Debt-service costs | 162.6 | 181.8 | 204.8 | 232.9 | 269.7 | 308.0 | 338.6 | 13.3% |
| Contingency reserve | – | – | – | – | 12.0 | 5.0 | 5.0 | |
| **Non-interest allocations available for division** | **1 242.3** | **1 324.8** | **1 486.2** | **1 571.3** | **1 552.5** | **1 557.8** | **1 567.5** | **-0.1%** |
| *Percentage increase* | *7.2%* | *6.6%* | *12.2%* | *5.7%* | *-1.2%* | *0.3%* | *0.6%* | |
| **Division of available funds** | | | | | | | | |
| **National departments** | **592.6** | **634.3** | **749.7** | **804.5** | **763.3** | **736.3** | **739.0** | **-2.8%** |
| *of which:* | | | | | | | | |
| *Indirect transfers to provinces* | *3.8* | *3.9* | *3.9* | *4.2* | *4.4* | *4.9* | *4.9* | *5.5%* |
| *Indirect transfers to local government* | *7.8* | *7.9* | *7.0* | *6.9* | *7.1* | *8.2* | *8.5* | *7.3%* |
| **Provinces** | **538.6** | **572.0** | **613.5** | **628.3** | **639.5** | **643.3** | **646.8** | **1.0%** |
| **Local government** | **111.1** | **118.5** | **123.0** | **138.5** | **138.1** | **146.1** | **148.4** | **2.3%** |
| Equitable share | 55.6 | 60.8 | 65.6 | 84.5 | 78.0 | 83.1 | 83.6 | -0.4% |
| Conditional grants | 43.7 | 45.3 | 44.2 | 40.0 | 45.5 | 47.7 | 49.4 | 7.3% |
| General fuel levy sharing with metros | 11.8 | 12.5 | 13.2 | 14.0 | 14.6 | 15.3 | 15.4 | 3.2% |
| Provisional allocation not assigned to votes[1] | – | – | – | – | 11.6 | 32.1 | 33.2 | |

*1. Includes support to Eskom, amounts for Budget Facility for Infrastructure projects and other provisional allocations*
*Source: National Treasury 2021 Budget Review 2021*

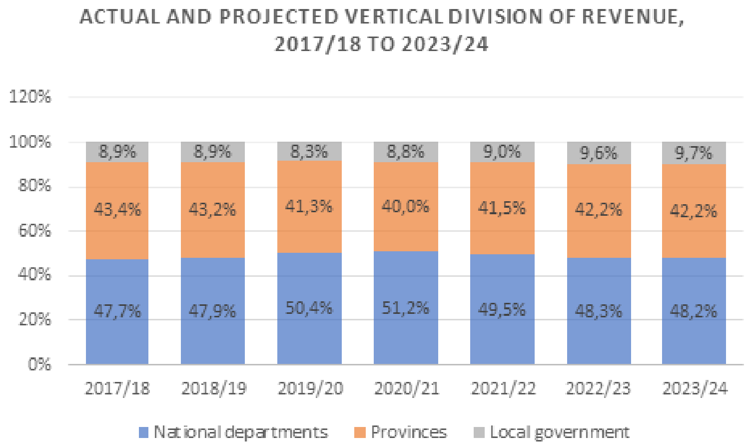
From this amount, debt service costs to pay the interest on existing debt is top-sliced as a first charge on expenditure, along with the contingency reserve. **The remainder is then split among national departments, provinces and local government.**

*Example: In 2021/22, the table reflects that R763.3 billion accrued to national departments, R639.5 billion to provincial departments and R138.1 billion to the local government sphere. In that year, about 56% of local government revenue came from the unconditional Local Government Equitable Share Grant (LGES), and a further 33% from conditional grants, mainly infrastructure related. Metropolitan governments (large cities) also get a share of the revenue from the fuel levy.*

## How has the vertical division of revenue changed over time?

The national government's share of nationally collected revenue increased until 2020/21, while provincial and local government's shares decreased.

After 2020/21 to 2023/4, however, national government's share started to decline and that of provinces, while local government's share rose by 97%.




## How is the Local Government Equitable Share Grant (LGES) expected to grow in the medium term?

As shown by the row highlighted in yellow in the table, over the medium term (2021/22 to 2023/24), the LGES is expected to decline in nominal terms from R84.5 billion in 2021/21 to R83.6 billion in 2023/24 – an average annual rate of contraction of -0.4%. Yet over the Medium-Term Revenue and Expenditure Framework, costs of compensation of employees and bulk water and electricity are expected to increase markedly.

**Conclusion:**

- The LGES declines at an average annual rate of -0.4% over the MTEF period before inflation is taken into account. If the inflation rate is 4 to 6% over the same period (ie. within the inflation target range), then the actual purchasing power of municipalities after inflation will be more severely impacted (contracting roughly -4.4% to -6.4% in real terms)

- The own revenue sources of municipalities have been eroded as pandemic related unemployment and losses of livelihood have increased since 2019.

- Over the medium term this decline in revenues coupled with the escalating wage bill and bulk service costs will undermine local government's ability to deliver basic services and create local environments conducive to economic growth and investment.

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